(including the BOCs' long distance affiliates) providing local service using their own facilities or unbundled network elements will be able to avoid payment (or even imputation in the case of the BOCs' affiliates) of access charges in their combined local/long distance offerings.

Excessive access rates undeniably create both the incentive and ability for this type of "price squeeze" behavior (NPRM ¶ 148).[20] But the harm to competition is not limited to interexchange markets. As customers increasingly demand "one-stop shopping" for bundles of local exchange, exchange access, and toll services, ILECs can use their cost advantage to protect their local markets as well. "This artificial advantage may allow the BOC affiliate to win customers even though a competing carrier may be a more efficient provider in serving the customer."[21] High access rates inefficiently discourage resale competition, for example. The Commission has equally emphasized the importance of entry through the resale and UNE provisions of the Act. Indeed, the Commission has been emphatic about the importance of resale even though "resellers do not compete with incumbent LECs in the provision of access" because "this requirement is a 'stepping stone' in the provision of other forms of competition." NPRM ¶ 174. However, only facilities-based and UNE-based competitors can avoid excess access charges (and then only if they win the local customer), and thus all resale providers will be at a significant cost disadvantage. Thus, as the Commission has already concluded: "to the extent carriers offer both local and interLATA services as a bundled offering, a BOC that

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[20] See also, e.g., *Non-Accounting Safeguards* ¶ 11; Baumol, Ordover & Willig Aff. ¶ 3.

[21] *Non-Accounting Safeguards Order* ¶ 12.

discriminates against the rivals of its affiliates could entrench its position in local markets by making these rivals' offerings less attractive." Id. ¶ 11.[22]

In addition, the supracompetitive revenues that excessive access rates generate create a "war chest" available to finance additional anticompetitive activities. These would include exclusionary litigation targeted, for example, at delaying entry or obtaining higher UNE rates.[23] Perhaps most perversely, the existence of such a "war chest" may actually discourage the very facilities-based entry the Commission hopes to encourage (NPRM ¶ 142). A competitive local exchange carrier ("CLEC") will only construct new network components when it expects to earn a profit. If the incumbent carrier, however, can subsidize local services by tapping into its supracompetitive access revenues, the entrant cannot hope to succeed even when it has a lower cost of furnishing service. Hence, consumers may not gain the benefits that otherwise would accrue as a result of cost savings and technological improvements.[24] By contrast, it is well settled that the efficient level of entry will be encouraged by efficient rates.

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[22] See also Baumol, Ordover & Willig Aff. ¶¶ 17, 21.

[23] GTE, for one, appears already to have embarked upon such a campaign.

[24] See Baumol, Ordover & Willig Aff. ¶ 21. In addition, monopoly rents earned on inflated access fees may, encourage overbuilding. See, e.g., Avinash Dixit, "The Role of Investment in Entry-Deterrence," The Economic Journal, (March 1980); United States v. Aluminum Company of America, 148 F.2d 416 (2nd Cir. 1945). Higher levels of capacity can provide a credible threat against a potential rival that competition post-entry will be vigorous and unprofitable. Moreover, the stream of excess revenues produced by above-cost access prices provides the needed income for these capacity investments. It is thus not surprising that overbuilding has been widely observed among ILECs.

C. TELRIC Is The Appropriate Measure Of Efficient Cost-Based Access Prices.

Given the perverse effects described above, it is not surprising that "[t]here is a consensus among virtually all participants in the telecommunications industry on the need to reform . . . interstate access charge rules" (NPRM ¶ 41). AT&T fully supports the Commission's goal in this proceeding "to move towards significantly more cost-based access rates." Id. ¶ 112.

The path to determining cost-based access rates is by now well traveled. The only tool the Commission needs to determine economically efficient cost-based access rates is the same "cost-based pricing methodology based on forward-looking economic costs" which the Commission adopted in the *Local Competition Order* as "the approach for setting prices that best furthers the goals of the 1996 Act."[25] As the Joint Board has since noted, "[t]hose costs best approximate the costs that would be incurred by an efficient competitor."[26] Thus, as the former Chief Economists of the Justice Department's Antitrust Division have confirmed: "Prices based on forward-looking costs give the right signals to both producers and consumers to ensure the efficient use of resources. This has long been recognized by professional economists and has been an informing principle of antitrust and regulatory policy."[27] Accordingly, such "forward-looking costs form the appropriate basis for determining whether

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[25] *Local Competition Order* ¶ 620.

[26] Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision ¶ 270 (released Nov. 8, 1996).

[27] Chief Economists' Letter at p. 1.

rates charged to new entrants by the incumbent carriers in local markets are fair, reasonable, and efficient."[28]

For these reasons, AT&T fully supports the Commission's tentative conclusion that efficiency determinations in the access context should focus on total service long-run incremental cost ("TSLRIC"), or its "element" variant, total element long-run incremental cost ("TELRIC"), as do the Commission's network element pricing rules and the Joint Board's universal service recommendations. As the Commission has acknowledged, "It is well recognized that access charge reform is intensely interrelated with the local competition rules of Section 251 and the reform of universal service."[29] Indeed, key access elements such as switching and transport are virtual twins to their switching and transport network element counterparts -- "[w]hether traffic originates locally or from a distant exchange, transport and termination of traffic by a particular LEC involves the same network functions." NPRM ¶ 9.[30] Thus, TELRIC pricing of access, like TELRIC pricing of unbundled network elements (and universal service), "should encourage efficient and effective entry into the local telecommunications marketplace" (¶ 222) and foster both the primary objective of the Act and the Commission's goals in this proceeding.

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[28] Id.

[29] *Local Competition Order* ¶ 8; See also FCC Staff Analysis, The Use of Computer Models for Estimating Forward-Looking Economic Costs ¶ 11 (Jan. 9, 1997) (forward-looking "[p]roxy models may be utilized for multiple regulatory objectives, such as in a prescriptive approach to access reform, determining levels of universal service support in high cost areas, and the pricing of unbundled network elements").

[30] See also ¶ 225 ("it is not clear that the TSLRIC price of dedicated transport service . . . should significantly differ from the TELRIC of a dedicated transport element").

No other standard could satisfy the Act's demands or eliminate the unreasonableness inherent in the current regulatory system. Indeed, given that the Commission has already adopted long-run incremental pricing for UNEs (under a methodology that considers both local exchange and exchange access use of local facilities in determining unit prices), and for determination of universal service payments, any other standard would be arbitrary and capricious.

II. THE COMMISSION SHOULD ADOPT A "COMPETITIVE PRICING" APPROACH BY REINITIALIZING PRICE CAPS.

The TELRIC-based "prescriptive" alternative to price cap reform proposed in the NPRM would, by definition, quickly move access rates toward efficient cost-based competitive levels. Indeed, this is the *only* one of the proposed alternatives that can achieve this goal. For reasons explained in more detail below, the Commission cannot reasonably rely upon nonexistent competition to gradually and incompletely reduce access rates. Faced with a choice of taking action that will address the problems with access that the Commission has identified and serve its stated goals, or doing nothing, the appropriate course is clear -- the Commission must affirmatively drive out the excesses in current access rates. No countervailing public interest determination, much less a compelling one, supports leaving access price caps at their current inflated levels.[31]

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[31] Although AT&T in these Comments focuses on price cap LECs, the same legal and economic bases require reducing the access rates for rate-of-return LECs to efficient cost-based levels, and AT&T requests that the Commission initiate a further rulemaking to address that issue.

As an initial matter, the legislative history indicating that Congress envisioned deregulation of telecommunications markets in the long term provides no basis for preferring the "market-based" proposal over the "prescriptive" alternative. See NPRM ¶ 142. The only deregulatory features of the "market-based" approach are separate proposals to relax price cap basket, service band and other restrictions upon certain competitive showings. But the decision whether and when to implement those changes is independent of the determination whether excessive price cap levels should be reduced to more competitive levels today, given that market forces plainly do not now constrain ILEC access prices. Thus, even if the phased-in pricing flexibilities that the NPRM bundles with the "market-based" approach were appropriate (which they now are not, for reasons explained in Section VII), they could just as easily be bundled with the "prescriptive" approach.

As explained below, the two other putative disadvantages of reinitialization raised in the NPRM are equally illusory. First, because key carrier access elements are not functionally different from corresponding network elements (as the Commission recognizes, see NPRM ¶ 9), and because good TELRIC proxies for those elements are readily available from both state commission determinations and proxy models, reinitialization of the LECs' price caps is not a difficult matter. Reinitialization will work, and whatever administrative burdens it may ultimately impose on the parties and the Commission will be more than offset by the enormous dividends that will flow directly to consumers. Second, claims by ILECs that they have some constitutional, "regulatory compact" or other entitlement to the levels of access revenues

generated by their current excessive rates are false and, indeed, can be expected in response to any effective tool the Commission employs to drive those rates to more efficient levels.

A. Reinitialization Of Price Caps Is Easier To Administer Than The "Market-Based" Approach.

There can be no serious argument that reinitialization of ILEC price caps is a task beyond the capabilities of the Commission or the parties. The existing access price cap rules are complex themselves, and properly recognize the need for occasional exogenous adjustments. As a result, the Commission has conducted detailed price cap determinations on a nearly continual basis since the price cap system was initiated. Thus, even if reinitialization would "require[] the Commission to make detailed determinations of appropriate price levels for multiple services throughout the country" (NPRM ¶ 143), that both could and should be done. Concern over the Commission's and the parties' convenience cannot rationally counterbalance billions of dollars in foregone consumer welfare gains.[32]

But an effectively implemented reinitialization approach would not "require the Commission to make detailed determinations of appropriate price levels for multiple services throughout the country." NPRM ¶ 143. Rather, the Commission can instead focus on a handful of key carrier access elements that together account for almost all access revenue (and thus most excess charges) and rely heavily on the existing evidence of appropriate price levels established by recent state determinations addressing equivalent network elements. This approach will make reinitialization easily manageable, drive access prices toward efficient

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[32] See, e.g., United States v. FCC, 652 F.2d 72, 96 n.109 (D.C. Cir. 1980) (en banc) ("[c]onsiderations of administrative difficulty, delay, or economic cost would not suffice to permit the agency to avoid its duties under the Act").

cost-based levels, and foster consistency between state and federal prices for the same network functionalities.

Although there are hundreds of access elements in some ILECs' traffic sensitive and trunking baskets,[33] four such elements -- the per-minute local switching element in the traffic sensitive basket, the per-minute tandem switching and common transport elements, and the dedicated transport elements (generally separately priced at the DS0, DS1 and DS3 levels) in the trunking basket -- account for virtually all of the revenues. The local switching element, for example, generally accounts for nearly 90% of the revenues in the traffic sensitive basket. Similarly, after removing the non-cost-based TIC, which is separately addressed in Section IV below, the access tandem switching and transport elements account for the lion's share of the revenues associated with the trunking basket.[34] Accordingly, focusing on these key carrier access elements alone is a rational initial approach to access reform.[35]

Relying on existing price data is equally appropriate. As the Commission has repeatedly recognized, an ILEC's switching and transport of an interexchange call uses the same network facilities and functionalities in the same way as its switching and transport of

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[33] Although the reinitialization approach laid out here could also be applied to the common line basket, it is more appropriate to assign all such costs (and line port costs) to the end users to whom they are dedicated, as described in section IV, infra.

[34] Readjusting the trunking basket price cap by focusing on the access tandem switching element will have the added benefit of helping to discharge the Commission's court-imposed obligation to revisit those rates. See CompTel v. FCC, 87 F.3d at 533.

[35] Although all access elements must eventually be driven to competitive market levels if artificial ILEC advantages are to be eliminated and full competition is to become a reality, AT&T does not oppose addressing less significant elements in later proceedings and on less compressed schedules.

a local call.[36] "A minute is a minute is a minute,"[37] and any existing price distinctions between the two operations reflect not cost differences, but the legacy of divestiture and separations policies. Indeed, the unbundled network element TELRIC methodology includes exchange access minutes as well as local exchange minutes in determining appropriate unit costs. Thus, it is not surprising that an almost identically-defined unbundled network element exists for each of the key access elements. Indeed, it is precisely for that reason that network elements can be used to provide exchange access.

That understanding supports two critical conclusions. First, the same forward-looking, cost-based pricing standard that the Commission found best serves the public interest in pricing network elements, best serves the public interest in pricing their access element twins. Second, where appropriate forward-looking, cost-based prices have been determined for network elements, those prices provide a sound basis for pricing their access element counterparts.

In this latter regard, the Commission's assumption that "fewer costs will be directly attributable or dedicated totally to exchange access services" (NPRM ¶ 221) (emphasis added), and thus that common costs will create problems in the access context that they do not create in the network element context, is plainly misguided. Access elements, like their network

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[36] See, e.g., NPRM ¶ 9 ("[w]hether traffic originates locally or from a distant exchange, transport and termination of traffic by a particular LEC involves the same network functions"); id. ¶ 26 ("an incumbent LEC's provision of transport and local switching for terminating interstate traffic is functionally the same as its provision of transport and termination service under the 1996 Act").

[37] Communications Daily, Vol. 16, No. 144 p. 3 (July 25, 1996) (quoting FCC Chairman Reed Hundt).

element counterparts, "correspond, to a great extent, to discrete network facilities."[38] The facilities and functionalities are the same, and what works for one will work for the other.[39]

Second, functional equivalency also means that any ILEC claims that appropriately determined UNE rates understate the costs of providing equivalent access elements can safely be disregarded. Indeed, at least with respect to local switching, UNE rates, if anything, overstate access element costs, because costs associated with the software and other facilities used to provide the vertical features not used in exchange access switching are required to be reflected in UNE local switching rates.[40]

Most state commissions have by now reached at least one forward-looking cost-based price determination for the counterpart of each of the key access switching elements. Virtually all will have done so, or be well on the way to doing so, by the time this proceeding is concluded. Although, as always, there are a few outliers, the states have reached remarkably consistent determinations. Thus, with one exception, the local switching rates determined in arbitrations between AT&T and ILECs have all fallen within the range of $0.0015 to $0.005/minute -- nearly identical to the default proxy range the Commission established in the

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[38] *Local Competition Order* ¶ 695.

[39] Thus, although in some abstract sense the costs associated with an ILEC switch, for example, could be characterized as "common" to all uses of that switch, the local switching access element is amenable to the same direct minutes of use "allocation" employed in the network element context.

[40] *Local Competition Order* ¶¶ 816-817.

Local Competition Order.[41] By contrast, the current inflated local switching component of price cap ILEC interstate access rates is as high as $0.013809/minute and generally exceeds $0.007/minute. Fewer states have independently determined forward-looking transport rates, but again, many are in the process of doing so.

The Commission should "borrow" these state commission pricing determinations to determine appropriate access price cap adjustments. Such "partnering" with the states is an approach with which the Commission and the courts are familiar,[42] and it is especially appropriate in this context, given the functional equivalency of access elements and network elements, and the fact that states must also establish intrastate access rates and rates for the transport and termination of local traffic. See, e.g., NPRM ¶ 9 ("the rates that local carriers impose for the transport and termination of local traffic and for the transport and termination of long distance should converge").

Relying on state pricing determinations to move access price cap levels toward more efficient levels is also more than fair to the ILECs. The relevant ILEC has an opportunity to participate in each of the state proceedings, including an opportunity to advance its own view

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[41] See *Local Competition Order* ¶ 811 (establishing $0.002 to $0.004/minute range and grandfathering rates up to $0.005/minute).

[42] See, e.g. Southern Bell Tel. & Tel. Co. v. FCC, 781 F.2d 209, 217 (D.C. Cir. 1986); National Ass'n of Regulatory Util. Commissioners v. FCC, 737 F.2d 1095, 1124-25 (D.C. Cir. 1984). See also Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873, 3295-96 (1989) ("[r]ather than seeking to foreclose regulatory alternatives, Congress provided this Commission broad discretion in selecting methods . . . to make and oversee rates").

of the relevant costs and prices. Indeed, such state proceedings often offer more "due process" than paper hearings before the Commission.[43]

In practice, there will essentially be two steps involved in reinitializing price caps based on state commission UNE rate determinations. First, the Commission must determine which state commission determinations to borrow. Switching and transport costs are much less likely than loop costs to differ significantly across geographic areas. As noted above, however, state determinations, while generally consistent, have not been identical. Although determinations at or near the lower end of the state range are better estimates of the true forward-looking costs of those elements,[44] AT&T nonetheless recognizes that the benefits associated with interstate/intrastate and UNE/access consistency within each state support using each state's determinations to reinitialize access price caps associated with that state.[45] In some states there may not yet be UNE proxies for all of the key access elements. In these cases, because no further delay can be tolerated in realizing the consumer benefits associated with access

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[43] Moreover, AT&T would in all cases support limited Commission review procedures designed to ensure that the state commission in question purported to base rates on forward-looking costs, and broader review where the state commission determination falls outside some preestablished proxy range.

[44] Cf. *Local Competition Order* ¶ 815 ("the most credible [switching cost] studies in the record before us fall at the lower end of [the default proxy] range").

[45] For the same reason, even assuming it would be lawful to do so (see 47 U.S.C. § 254(g)), there should be no geographic deaveraging of access elements within a state or study area unless the state has also deaveraged rates for the functionally equivalent network elements. To date few (if any) states have done so with respect to the access elements at issue here, further confirming that no significant geographic cost differences exist.

reform, the Commission should use the median of all states' determinations for the missing elements.

At a minimum, the Commission should reinitialize price caps immediately on the basis of the forward-looking data that do exist, and revisit those price cap levels when more data become available.[46] Alternatively, the Commission could rely on cost estimates generated by the Hatfield Model, which currently provides accurate forward-looking cost estimates for most of the relevant network and access elements and soon will directly estimate the costs associated with all of the key access elements.

Second, the Commission must decide how, specifically, to translate the new forward-looking cost estimates for key access elements into price cap reductions. The Commission could establish new price cap levels, i.e., by applying the new rate for each key access element, along with existing rates for other elements, to historical demand figures. The new price cap indicies could then be calculated by comparing this result with currently allowed revenues for the traffic-sensitive and trunking baskets. The Commission could then either allocate the total reduction across all service categories in the relevant basket on an equiproportionate basis -- "Option 1" (NPRM ¶¶ 223-27) -- or target the reduction directly to the key elements themselves -- similar to the "Option 4" approach (NPRM ¶¶ 236-38). Because the key elements account for the vast majority of the revenues in their respective

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[46] Of course, in some states there may be multiple UNE rate determinations (because there have been multiple arbitrations). Generally, those determinations should not differ significantly, but because some smaller and more specialized CLECs with limited entry plans may not have aggressively pursued all elements, AT&T recommends that the Commission rely on the lowest state determination for each UNE. Cf. 47 U.S.C. 252(i).

baskets, the practical differences between these two approaches should be slight, and AT&T would support either.[47]

In short, the reinitialization approach outlined here is eminently manageable. Indeed, in the end it is likely to be far less burdensome than the "market-based" approach. That is because, absent real reform, this proceeding will not end the access debate. In the new regime created by the 1996 Act, non-incumbent carriers who are competitively disadvantaged by ILECs' excessive rates simply will have no choice but to avail themselves of all possible avenues to reducing those unlawful rates, including multiple complaint proceedings challenging the ILECs' access prices and practices as unjust, unreasonable and discriminatory.

B. ILECs Have No Entitlement To Any Make-Whole Payments.

The NPRM (¶ 248) also expresses concern that driving ILEC access prices toward more efficient levels might require the Commission to determine whether consumers should be forced to subsidize ILECs by funding some sort of "make-whole" payments. ILECs undoubtedly will raise this issue even though forward-looking, cost-based rates are fully compensatory, maximize consumer welfare and best serve the public interest. But that is no reason to delay welfare-maximizing access price cap reinitialization, because ILECs will raise the "underrecovery" issue in opposition to any reform that reduces their bloated access

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[47] AT&T opposes prescriptive "Option 2" (NPRM ¶¶ 228-30) and "Option 3" (NPRM ¶¶ 231-35) which would address excessive price cap levels only indirectly through rate of return decreases or X-Factor increases that are independently warranted and that should be made regardless of whether the Commission reinitializes rates. See Section V, infra; see also NPRM ¶ 236 ("None of those proposals would necessarily compel price cap incumbent LECs to adopt efficient rate structures, nor ensure that price cap incumbent LECs allocate common costs in a reasonable manner").

revenues, even gradually. Thus, the Commission cannot avoid the underrecovery "problem" unless it simply abandons its stated goal of moving access rates toward more efficient levels. Preliminarily, this underrecovery claim completely ignores the public and policy interests at stake in this proceeding. Reinitializing access prices will immediately generate a $10 billion annual dividend to all consumers -- a huge benefit that must be compared to the alleged private interests of ILECs and their shareholders.

In any event, under any rigorous examination, the "problem" of unrecoverable costs is entirely illusory. As a policy matter, claims regarding "underrecovery" grossly exaggerate relevant ILEC costs and understate the opportunities ILECs already have had and will have to recover them.[48] Indeed, it is highly unlikely that there has been or will be *any* underrecovery at all. But even if some isolated underrecovery claims could ultimately be substantiated, those claims could -- and should -- be handled through separate waiver proceedings. And, as a legal matter, so long as the ILECs have a fair opportunity as firms to secure a reasonable return on their prudently incurred investment, as they clearly, then regulators are free to maximize consumer welfare without further accommodation of shareholder interests. In short, alleged ILEC "underrecoveries" provide no basis whatever for delaying genuine, comprehensive access reform.

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[48] See, e.g., Home Box Office, Inc. v. FCC, 567 F.2d 9, 36 (D.C. Cir. 1977) cert. denied, FCC v. Home Box Office, Inc., 434 U.S. 829 (1977) ("a regulation perfectly reasonable and appropriate in the face of a given problem may be highly capricious if that problem does not exist").

1. ILEC Underrecovery Claims Rest Upon A Misunderstanding Of The Relevant ILEC Costs And Opportunities To Recover Those Costs.

In assessing the ILECs' "underrecovery" claims, it is important that the Commission understand that the ILECs have already recovered, and almost certainly will recover in the future, their legitimately incurred and relevant prior expenditures. In this regard, ILECs misstate the "underrecovery" issue at every step, including (i) the determination of relevant costs, and (ii) the characterization of the past, present, and future opportunities to recover those costs.

a. Relevant costs. In five crucial respects, ILECs grossly overstate the magnitude of relevant embedded costs. First, ILEC claims of "underrecovery" fail to exclude capital expenditures that are aimed at strategic objectives and new service goals, rather than meeting demand for basic services, including access. Indeed, ILECs have considerably misallocated costs to local network expenditures to subsidize their non-telephony activities, such as broadband and long distance investments.[49] Thus, unnecessary retirement of analog switches and replacement by digital switches, overspending on central office plant to meet demand for second and additional residential lines as well as other discretionary services, and spending for broadband digital services all exaggerate the capital expenditures that underlie the ILECs' claims of access-related "underrecovery." For example, approximately $30 billion of historical net book investment (as of the end of 1996), corresponding to roughly $9 billion in estimated annual costs, cannot be explained by basic service demand growth over the 1990-

[49] See January 29, 1997 Affidavit of Patricia D. Kravtin and Lee L. Selwyn at p. 11 ("Kravtin & Selwyn Aff.") (attached hereto as Appendix B).

1996 period.[50] This fact alone indicates that the ILECs have inflated the embedded "costs" attributable to interstate access (as well as understated the relevant revenues that should be offset against local network costs) by tens of billions of dollars.

Second, the claimed "underrecovery" also rests upon recent capital expenditures that cannot properly be linked to "unanticipated" regulatory changes. Most of the investment that ILECs now claim is "at risk" was undertaken after January 1, 1990, when price cap regulation replaced rate of return regulation. Indeed, as of year-end 1996, approximately 65% of ILEC historical book investment had been acquired after January 1, 1990.[51] After that date, there could be no legitimate shareholder expectation of guaranteed embedded cost recovery, if there ever was any such expectation. ILECs were fully able to manage their construction and investment programs and cannot now ask consumers to give them more than full compensation based on true economic costs, as TELRIC pricing would.

Third, in any event, ILEC arguments that underrecoveries have resulted from shortened useful lives and technological displacement ignore the fact that the ILECs have had ample opportunity to seek adjustments to price regulation based upon supported assessments of actual useful remaining lives of relevant local network plant. This is especially true for expenditures incurred and any resulting shortfalls under price cap regulation. In these circumstances, the ILECs should not be permitted to transform commercial and technological

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[50] See Kravtin & Selwyn Aff. at pp. 13-14.

[51] See Kravtin & Selwyn Aff. at p. 12.

developments that they failed to anticipate into subsidies from consumers.[52] It would be both unfair and inefficient to place that burden on the consuming public. In any event, there is no evidence that actual useful lives are shorter than lives approved by regulators; indeed, the evidence of a significant depreciation reserve shortfall is directly to the contrary.[53]

Fourth, for much of the pre-1990 ILEC plant, forward-looking costs are likely to exceed historical costs carried on ILEC books and, thus, there is obviously little risk of underrecovery. This is especially true as new narrowband services and technological developments, such as the ability to provide broadband services, increase the likely value of existing copper cable. Indeed, the available evidence indicates that, for as much as 70-80% of pre-1990 plant, current reproduction costs may be *higher* than historical embedded costs.[54]

Fifth, ILECs ignore the fact that, to be recoverable, costs must have been prudently incurred. The existing embedded costs reflect an accounting measure of actually incurred costs, but the prudence and efficiency of those expenditures have never been demonstrated.

b. Opportunities for cost recovery. Assuming there were any legitimate costs that have not already been recovered or would not be recovered through forward-looking rates, it is very unlikely that *any* ILEC would be unable to recover those (embedded) costs in the future. To begin with, if AT&T's proposed reinitialization is implemented, the annual revenue shortfall will be relatively small, even assuming that the ILECs would have no other

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[52] See Kravtin & Selwyn Aff. at p. 14.

[53] See January 29, 1997 Affidavit of Richard B. Lee ("Lee Aff.") at p. 1 (attached hereto as Appendix C).

[54] See Kravtin & Selwyn Aff. at p. 12.

opportunities to make up that shortfall through other activities. Total interstate carrier switched access revenues for 1995 were about $12.2 billion, as compared with a forward-looking economic cost of $1.6 billion, leaving a total "shortfall" if access charges were immediately reduced to cost (really a past overrecovery by the ILECs) of $10.6 billion. However, much of that amount should and would be recouped through other revenues, including the new Universal Service Fund (up to $4 billion). ILECs may also be able to demonstrate that those portions of the shortfall that represent removal of charges properly attributable to end users -- including, misallocated retail expenses ($0.8 billion), the Carrier Common Line Charge ($3.3 billion, after adjusting for marketing expenses)[55] and line card costs ($1.2 billion) -- should be "recouped" through increased end user charges. Even if there are increased end user charges, consumers will still be far better off overall under the new regime, because of the direct reductions in long-distance rates that will result from access charge reductions, as well as the additional efficiencies resulting from enhanced competition. And for the ILECs, the net result is that access revenues would be approximately $1.3 billion dollars lower than current levels -- a very small percentage of the ILECs' total revenues from regulated services of $90.8 billion, and an even smaller percentage of their *total* revenues.[56]

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[55] As discussed in detail below, there is no justification for retaining the CCLC. That element alone accounts for an enormous share of the current, unjustified cross-subsidy inherent in access rates.

[56] It bears emphasis that there is really no shortfall at all here, at least on a forward-looking basis, inasmuch as the ILECs would be collecting rates that recover their long-run incremental costs of providing the service.

But even this amount would contribute to an arguable "underrecovery" only to the extent an ILEC was unable to recover its costs through other means. ILECs subject to price cap and other incentive regulation (at the state or federal levels) have already had unusually good opportunities to recover the costs of local facilities used to provide access services. This is because such regulation allows carriers to earn a premium above their cost of capital if they operate efficiently. ILECs also have had substantial latitude and has been successful in seeking adjustments in depreciation schedules based upon changes in useful life or displacement by new technologies.[57] Although ILECs chose not to dedicate their surplus profits to cost recovery, there is no reason that the Commission must ignore them now in the face of anticompetitive ILEC "make-whole" claims. Those surplus profits alone -- totaling more than $7 billion even when measured against the S&P 500 -- likely dwarf any conceivable "shortfall" measure.[58]

The prospects for future recovery are even brighter. Even for the access component of pricing, decreased charges will increase demand, as will increased usage of long distance services for reasons unrelated to the elimination of the ILECs' monopoly rents.[59] These

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[57] See Lee Aff. at p. 6.

[58] See Kravtin & Selwyn Aff. at p. 25.

[59] In fact, ILECs typically underestimate the amount of demand they will face in the future. See Annual 1990 Access Tariff Filings, MM Docket No. 90-320, Memorandum Opinion and Order, ¶ 427 (released June 21, 1990) ("Our analysis of LECs' past forecasting performance indicates that the LECs have generally underforecast substantially"); Annual 1989 Access Tariff Filings, DA 89-337, Memorandum Opinion and Order, ¶ 462 (released March 22, 1989) ("LEC forecasts, both on a total industry and individual company basis, (continued...)

developments will provide further opportunities for recovery of any "shortfall" resulting from the recalibration of access price caps.[60]

The ILECs, moreover, have ample opportunities to offset any embedded costs through revenues from a range of services extending beyond access services. ILECs incur costs for local network facilities, not for particular regulated services, and ILECs have an opportunity to recover their facilities costs from all their revenues (including those derived from those facilities), not only from certain revenue streams linked to particular regulated services.[61] Sections 251-52 of the 1996 Act will greatly widen the scope of Commission-regulated services employing local facilities, thus providing even greater interstate revenues that can

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[59](...continued)
understate likely CCL demand by a . . . significant amount"); Annual 1987 Access Tariff Filings, DA 86-453, Memorandum Opinion and Order, ¶ 102 (released Dec. 24, 1986) ("the LEC and its officers have a substantial incentive to be conservative in their demand estimates, leaving wholly to one side all implications of bad faith")

[60] The Commission noted similar problems in rejecting underrecovery objections to its original access charge scheme. See MTS and WATS Market Structure, Memorandum Opinion and Order, 97 FCC 2d 834 ¶ 46 (1984) ("we conclude that petitioner may have overstated the amount of investment that would truly be stranded -- i.e., unusable")

[61] Thus, the ILECs generally ignore that the allocation of costs among interstate and intrastate "uses," and the matching of costs to specific revenue streams, are solely accounting artifices. They are not probative, much less determinative, of whether ILECs have in fact had an opportunity to recover their reasonably incurred costs. Indeed, the determination and allocation of book value according to Parts 32, 36, 64, and 69 of the Commission's rules is, as the NPRM indicates (¶ 6), distorted in important respects, either by accident, or for public policy reasons unrelated to permitting ILECs the opportunity to recover their actual investment. The ILECs' regulated books thus undoubtedly overstate investment that is yet to be recovered. For example, as discussed in more detail in Section V below, investment associated with General Support Facilities is over-allocated to interstate access, to the tune of some $120 million per year. And approximately $1 billion of retail expenses are improperly allocated to interstate access. In such cases, the resulting accounting allocation in no sense reflects unrecovered costs.

offset any legitimate embedded costs. Revenues derived from the ILECs' own interstate services, especially value-added vertical services, also increased with the passage of the 1996 Act and will increase substantially if the RBOC ILECs satisfy the standards for additional long-distance entry.[62] More broadly, ILECs now have ample opportunities to recover embedded costs through the provision not only of regulated local exchange services, but also of other services such as yellow pages, customer calling services, enhanced services, and Block B cellular franchises.[63]

It is simply inconceivable that the ILECs as a group would not earn enough from all these services, above and beyond their forward-looking costs, to cover any "shortfall." (Kravtin & Selwyn Aff. at p. 17). And it is even more inconceivable that the ILECs would not at least have a fair opportunity to earn in excess of that amount. No legitimate policy basis exists to justify a consumer subsidy for an ILEC whose revenues from local exchange, exchange access, and all other services (including enhanced services) have exceeded or may exceed the actual costs of prudently managed investment in the facilities used to provide those services.

That the ILECs will have ample opportunity to recover their investments is further confirmed by the market valuation of those firms. Shares of regulated entities that are likely

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[62] See Kravtin & Selwyn Aff. at pp. viii, 20-21.

[63] The Commission may consider intrastate revenues so long, as here, they are not used to justify a rate that would otherwise be confiscatory. Consideration of overall revenues and expenditures is necessary and appropriate here to determine whether to credit ILEC policy-based claims that regulation has in fact precluded ILEC recovery of actual expenditures on local network facilities.

to recover costs plus a reasonable return generally trade at close to their book value. However, ILECs' shares now trade considerably above book values, indicating that investors have great confidence in the ILECs' ability to recover all their costs (embedded and ongoing) plus an unusually high return.[64]

Finally, the ILECs, like all firms facing the prospect of competition for the first time, are engaging in substantial restructuring and cost reduction. That process should yield even greater returns for unregulated and regulated services, including interstate access. As important, the ILECs' projected returns, including likely returns for regulated services, far exceed those required to recover any remaining embedded costs plus a reasonable return. Analysts and the ILECs' own officers predict robust earnings as the 1996 Act is implemented.[65] These earnings dwarf any arguable "shortfall" that would be created by a

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[64] See Kravtin & Selwyn Aff. at pp. 18-19.

[65] See, e.g., BellSouthnews, "Long Distance and Video: We've Only Just Begun, http://www.bellsouthcorp.com/investor/bellnews/nov96/art, (November 1996) ("BellSouth's long distance opportunity is huge") Id. ("BellSouth's video strategy is also geared toward profitable growth. . . Our trials in Chamblee, Georgia - a suburb of Atlanta - and the hihg customer take rates show that we will win in the video business."); U S West 1995 Annual Report ("We're also ready to compete aggressively for new business, and preparing to enter the interLATA long-distance, wireless and cable television markets, so we can offer customers full-service communication packages"); Merrill Lynch, RBOCS/GTE, "4Q Preview: Solid Finish to a Strong Year," (January 7, 1997) ("We believe the opportunities for the RBOCs/GTE outweigh the regulatory and competitive risks, even in the realistic worst case. Therefore, we continue to review RBOC/GTE shares as moderately attractive"); Bell Atlantic, "Network Services Strategic Overview," http://www.bell-atl.com/invest/businvpr/netserv/overview ("Bell Atlantic Strategic Overview") ("Our landline network platform provides the best and most efficient delivery architecture for the widest range of new services and margin opportunities, especially as our modernization program migrates our network to an ATM switched digital broadband full service platform").

reinitialization of access charges, and they would be available to cover any such shortfall as well.

2. The Underrecovery "Problem" Creates No Legal Impediment To Reinitializing Price Caps To Better Reflect Forward-Looking Costs.

In any event, no legal impediment exists to maximizing consumer welfare by reinitializing price caps to reflect forward-looking economic costs. The Constitution requires only that a regulated entity have a fair opportunity to secure a reasonable return on its overall investment. See Duquesne Light Co., 488 U.S. 299, 310, 312-16 (1989); Federal Power Comm'n v. Texaco, 417 U.S. 380, 391 (1974); Hope Natural Gas, 320 U.S. at 603. An administrative agency is "not bound to the use of any single formula or combination of formulae in determining rates," Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944), nor even "to include in the rate base all actual costs for investments prudent when made." Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254, 1263 (D.C. Cir. 1993); see also Duquesne Light Co. v. Barasch, 488 U.S. 299, 315-16 (1989); Hope Natural Gas Co., 320 U.S. at 601. Applying these standards and placing the burden of proof on the regulated entity, the Supreme Court has twice directly held that regulators are free to adopt new ratemaking principles that preclude recovery of embedded-type book costs. See Duquesne Light Co., 488 U.S. at 299 (new rate rule can bar utility's capital expenditure recovery, through amortization or inclusion in subsequent period rate base); Hope Natural Gas, 320 U.S. at 591 (upholding rate rule that limited capital recovery through depreciation disallowances).

A taking, moreover, cannot be found unless a rate order produces overall rates so low as to "jeopardize the financial integrity of the [regulated] companies, either by leaving them

insufficient operating capital or by impeding their ability to raise future capital." Duquesne Light Co., 488 U.S. at 312; see Federal Power Comm'n v. Texaco, 417 U.S. at 391-92; Hope Natural Gas, 320 U.S. at 607. Even ILECs do not remotely suggest that any of them would face that prospect.[66] Forward-looking rates expressly designed to provide a reasonable profit and cover a reasonable share of joint and common costs will, by definition, allow ILECs to continue to raise future capital. And no basis exists to conclude that forward-looking pricing would be so financially crippling as to leave ILECs insufficient capital to continue operating. Indeed, as described above, ILECs have likely already had and almost certainly will have the opportunity to recover their legitimate investment, even if one focuses solely on investment that has been allocated to the interstate jurisdiction.

Thus, even if current claims that "underrecovery" will occur were credible, there has not been (and could not plausibly be) any suggestion that a competitive market-based limitation on access recovery is so onerous that it will deprive ILECs of the opportunity as firms to earn a fair return on their total investment. To the contrary, both prior and ongoing

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[66] Indeed, even the most conservative ILEC estimates of their earnings potential over the next few years suggest new opportunities for investors to earn strong returns, not face potential insolvency. See, e.g., Bell Atlantic Strategic Overview ("We are planning to capture atleast 20 percent of the $10 billion in-region market share within five years of entry"); Mark Rockwell, "Bells Plan Service Push," CommunicationsWeek, at p. 70 (January 13, 1997) ("Pacific Bell Communications hopes to capture large, medium, and small business customers with pckages of local, long distance, wireless, Internet access, ceiling card and 800 services. [Pacific Bell] expects to meet the FCC's . . . competitive checklist and win commission approval for service in California on the first try").